No. 15,046

United States Court of Appeals

For the Ninth Circuit

WELLS FARGO BANK & UNION TRUST CO., Executor of the Will of Walter D. K. Gibson, Deceased,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

BRIEF FOR APPELLANT.

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vs.
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BRIEF FOR APPELLANT.

JURISDICTION.

This action was brought in the District Court under section 1346(a)(1), title 28 U.S.C., for the refund of federal income taxes erroneously assessed and collected. On June 30, 1947, appellant filed a claim for refund of said taxes paid. On April 13, 1950, the Commissioner of Internal Revenue notified appellant that its claim for refund was partially disallowed in the amount of $7,100.35. On April 11, 1952, appellant filed its complaint in this action to recover said $7,100.35, with interest (R. 5). The judgment of the District Court was entered on November 25, 1955 (R. 48). Appellant filed its notice of appeal to

this Court on January 23, 1956 (R. 49).[1] The jurisdiction of this Court rests on sections 1291, 1294 and 2107, title 28, U.S.C.

OPINION BELOW.

The memorandum opinion of the District Court (R. 37) is reported at 134 F.Supp. 340.

QUESTIONS PRESENTED.

1. Whether the income received by the estate of a deceased husband during administration is wholly taxable to the estate, or taxable half to the estate and half to the surviving wife where the estate was comprised entirely of community property in which the husband and wife had present and equal interests at the time of the husband's death.

2. Whether in such a case the income received by the estate is wholly taxable to the estate, or half to the estate and half to the surviving wife where the wife consented to take under the husband's will, but retained the right to withdraw half of the estate.

3. Whether the defense of equitable recoupment applies to prevent a recovery by appellant in this case.

[1]The United States, appellee herein, also filed a notice of appeal from the judgment of the District Court which denied appellee's motion to file a counterclaim. The appeal was dismissed on March 16, 1956, pursuant to stipulation of the parties.

STATEMENT OF FACTS.

Appellant is the executor of the will of Walter D. K. Gibson, deceased, who died on December 21, 1938 (R. 17, Stip. par. 2). Walter D. K. Gibson is hereinafter referred to as the "decedent." The estate of Walter D. K. Gibson, hereinafter referred to as "Walter's Estate," was in the course of administration from January 11, 1939, to August 26, 1941, when it was distributed under a decree of final distribution, but appellant was nevertheless not discharged as executor (R. 17, 18, Stip. par. 2).

Decedent's will was executed on August 31, 1937 (R. 18, Stip. par. 2). Decedent's wife, Emily A. Gibson (hereinafter referred to as "decedent's wife"), executed on August 31, 1937, a waiver whereby she elected to take under decedent's will (R. 18, Stip. par. 2, Ex. 2[2]), and she did in fact take under decedent's will (R. 18, 19, Stip. pars. 2 and 4).

All the property owned by decedent and decedent's wife at the date of his death was community property in which during the continuance of the marriage relationship decedent and decedent's wife had present, existing and equal interests. Walter's Estate was composed entirely of such community property and his estate was distributed in accordance with the provisions of decedent's will (R. 18, 19, Stip. par. 4).

Under decedent's will decedent's wife had the power to withdraw 50 per cent of Walter's Estate. She exercised

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[2]Exhibits 5 and 6 to the stipulation are printed in the transcript of the record; Exhibits 1-4 and 7 are contained in the record on appeal but not printed in the transcript due to the lengthy nature of the materials involved.

that power on May 8, 1941, and assigned the property to the Crocker First National Bank of San Francisco to hold as trustee under a trust agreement (R. 18, Stip. par. 3, Ex. 4).

Included in the gross income of the 1941 fiduciary income tax return of Walter's Estate was $19,690.65. This amount represented one-half of the income attributable to the property subject to administration in Walter's Estate for the period from January 1, 1941, to August 26, 1941. The return showed an income tax due of $3,815.44 which tax was paid in full (R. 19, Stip. par. 5). The other half of the income for this period attributable to the property subject to administration in Walter's Estate was reported on the last income tax return filed for decedent's wife. This return was for the period from January 1, 1941, to November 24, 1941, on which latter date decedent's wife died (R. 19, Stip. par. 6). The taxpayer for this period is hereinafter referred to as "Emily A. Gibson, deceased."

In a report dated November 6, 1944, the Internal Revenue Agent in Charge at San Francisco proposed adjustments to the return filed by Walter's Estate. The major adjustment was based upon the agent's determination that all the income attributable to property subject to administration in the estate from January 1, 1941, to August 26, 1941, should be reported by the estate for income tax purposes. Under this adjustment the half of the income from property subject to administration reported in the return of decedent's wife ($19,690.65) was added to the taxable income of Walter's Estate for the period involved (R. 19, 20, Stip. par. 9). On November 6, 1944, the same

Revenue Agent issued a thirty-day letter advising Emily A. Gibson, deceased, that there had been an overassessment of income taxes due from her for the period from January 1, 1941, to November 24, 1941. One of the adjustments proposed in the letter was a reduction in taxable income in the sum of $19,690.65 (R. 20, Stip. par. 8).

On January 22, 1945, the Commissioner of Internal Revenue (hereinafter referred to as the ''Commissioner'') wrote the executors of the Estate of Emily A. Gibson, deceased (hereinafter referred to as ''Emily's Estate''), proposing that the overpayment apparently due to Emily A. Gibson, deceased, be applied against the deficiency apparently due from Walter's Estate (R. 21, Stip. par. 9, Ex. 5). The executors of Emily's estate ultimately consented to have the overpayment credited against the deficiency due from Walter's Estate (R. 21, Stip. pars. 9 and 10, Ex. 6). Emily's Estate was subsequently reimbursed by Walter's Estate for the amount thus credited against the deficiency (R. 23, Stip. par. 12, Ex. 6).

The manner in which the deficiency plus interest of $10,708.82 which was charged against Walter's Estate was ultimately paid is set forth in paragraph 11 of the stipulation (R. 22). The deficiency plus interest paid by Walter's Estate was chargeable to the beneficiaries or transferees of the beneficiaries under the will of decedent as follows:

> 50% thereof to Crocker First National Bank of San Francisco, as transferee of decedent's wife;
>
> 12½% to Walter D. K. Gibson, Jr.;
>
> 12½% to the Joanne Gibson trust; and
>
> 25% to the Grace G. Collins trust (R. 22, Stip. par. 12).

On June 30, 1947, Walter's Estate filed a claim for a refund of the addition tax paid (R. 23, Stip. par. 13). On April 8, 1948, the Internal Revenue Agent in Charge at San Francisco advised Walter's Estate of a report by a representative of that office recommending that the overassessment be allowed (R. 23, Stip. par. 14). On April 12, 1950, Walter's Estate received a certificate of overassessment certifying that its income tax for 1941 had been overassessed by $9,362.58. However, such overassessment was reduced on the certificate by the sum of $7,100.35, which sum was the amount of a proposed deficiency in tax due from Emily A. Gibson, deceased, and by the further sum of $201.39, which is not here in dispute (R. 24, Stip. par. 15). Walter's Estate received a check for the net overassessment of $2,060.84 plus interest (R. 24, Stip. par. 16). On April 13, 1950, the Commissioner notified Walter's Estate that the claim for refund was disallowed to the extent of $7,100.35 (plus $201.39, which is not here in dispute) (R. 24, Stip. par. 16).

In the 30-day letter dated January 25, 1949, addressed to Emily A. Gibson, deceased, the taxpayer was advised that a deficiency in income taxes for the period ending November 24, 1941, had been proposed in the amount of $7,100.35. For an explanation of the adjustments made therein, the letter referred to the report on Walter's Estate which is Exhibit 7 attached to the stipulation. The proposed deficiency was due to a determination by the Revenue Agent that one-half of the income received by the executor of Walter's Estate during said period was taxable to Emily A. Gibson, deceased (R. 25, Stip. par. 17). Taxpayer Emily A. Gibson, deceased, protested said

proposed deficiency on the ground that the statute of limitations had expired and that section 3801 of the Internal Revenue Code of 1939 providing an extended statute of limitations in regard to related taxpayers did not apply. No further steps have been taken by the Internal Revenue Agent in Charge at San Francisco subsequent to the protest of Emily A. Gibson, deceased (R. 25, 26, Stip. par. 18). Thus no statutory notice of deficiency has ever been issued by the Commissioner against Emily A. Gibson, deceased, or Emily's Estate for the amount of $7,100.35 to which appellee alleges its rights are superior to those of appellant (R. 26, Stip. par. 19).

Emily's Estate was distributed in accordance with a decree of final distribution entered on January 23, 1947. Walter D. K. Gibson, Jr., and Grace Collins shared equally as residuary legatees of Emily's Estate. They each received cash and assets valued at $9,717.50 (R. 26, Stip. par. 20).

If the judgment prayed for herein is granted, the refund payable to appellant will be distributed in accordance with paragraphs 9 and 12 of the decree of final distribution of Walter's Estate dated August 26, 1941 (R. 26, Stip. par. 21, Ex. 3). A distribution according to the terms of said paragraph 9 is summarized in the supplemental stipulation of facts (R. 33).

The parties have agreed that the amount of tax in dispute, exclusive of interest, is $7,100.35 (R. 28, Stip. par. 24).

SPECIFICATION OF ERRORS.

The District Court erred:

1. In holding that the election by Emily A. Gibson to waive her community property right and take according to the will changed the character of the community interest upon the death of her husband and the entire community property became the estate of the husband.

2. In holding that the Commissioner properly determined in accordance with law that the executor of the estate of Walter D. K. Gibson, deceased, was liable for income taxes based upon the entire net income of the estate for the period from January 1, 1941, to August 26, 1941.

3. In failing to hold upon the facts and the law that one-half of the net income received by the estate of Walter D. K. Gibson, deceased, for the period from January 1, 1941, to August 26, 1941, was taxable to the executor of said estate, and that one-half of the net income was taxable to Emily A. Gibson.

4. In entering judgment that the appellant's complaint and cause of action therein be dismissed.

SUMMARY OF THE ARGUMENT.

1. Under the controlling authorities only one half of the income of Walter's Estate is taxable to the estate. The decision by this Court in *Bishop v. Commissioner,* 152 F.2d 389 (1945), requires a reversal of the District Court's judgment. In the *Bishop* case this Court held that one-half of the income received by the husband's estate was

taxable to the surviving widow where all the property of the estate was community property in which husband and wife had held present and equal interests. The fact that the wife's share of the community property was subject to administration in the husband's estate did not change this result. In the case at bar, Walter's Estate was composed of community property in which decedent and decedent's wife had held present and equal interests. Decedent's wife consented to take under decedent's will. It is appellant's position that the election by decedent's wife is not binding upon her under California law. But even if this Court should hold the election binding, decedent's wife retained the power to withdraw one-half of the estate subject to administration, and she exercised that power. Therefore, decedent's wife in the case at bar had the same power over her one-half of the community property subject to administration in Walter's Estate as did the surviving wife in the *Bishop* case. Thus the *Bishop* case, and other authorities cited in the argument, require a decision for appellant.

2. As an alternative defense appellee avers that if appellant has the right to recover under the applicable law, still its recovery should be denied under the doctrine of equitable recoupment. That doctrine does not apply in this case. The Supreme Court has given the doctrine an extremely narrow application which would prevent its application here. Furthermore, other decisions prevent the application of equitable recoupment here because, (1) the Commissioner was guilty of laches in failing to assess a tax against Emily A. Gibson, deceased, and (2) there is a lack of identity of the parties

as between the beneficiaries of Walter's Estate and the beneficiaries of Emily's Estate. Finally, specific provisions of the Internal Revenue Code prevent the application of the doctrine of equitable recoupment in this case.

ARGUMENT.

I.

ONLY ONE-HALF OF THE INCOME IS TAXABLE TO WALTER'S ESTATE UNDER THE DECISION IN BISHOP v. COMMISSIONER.

A. The Bishop Case.

It is the position of the appellant that the decision by this Court in *Bishop v. Commissioner,* 152 F.2d 389 (1945), is controlling in the case at bar.

In the *Bishop* case the husband died on December 20, 1938. At that time the husband and wife owned community property acquired by them while living in California, and in which at the time of the decedent's death each had "present, existing and equal interests." In the case at bar at the time of decedent's death decedent and decedent's wife each had present, existing and equal interests in community property acquired in California (R. 18, 19, Stip. par. 4).

The principal question in the *Bishop* case was whether during the period of administration of the estate the surviving widow was entitled to report one-half of the income received by the estate from the community property which had been accumulated by the husband and wife. The Court emphasized the following two provisions of the California Probate Code:

Section 201, which provides in part:

> "Upon the death of either husband or wife, one-half of the community property belongs to the surviving spouse; the other half is subject to the testamentary disposition of the decedent * * *."

Section 202, which provides in part:

> "Community property passing from the control of the husband, either by reason of his death or by virtue of testamentary disposition by the wife, is subject to his debts and to administration * * *."

The Court held that the wife was entitled to report one-half of the income from the property held by the estate which had formerly been the community property of the husband and wife. The Court's reasoning was stated succinctly as follows:

> "Being the owner of a one-half interest in the community property, petitioner (wife) owned one-half of the income therefrom. Since ownership is the test of taxability, petitioner's half of the $4,563.40 was taxable to her, not to the estate."

The Court also noted that the wife's one-half of the community property never became a part of the husband's estate, citing *United States v. Goodyear,* 99 F.2d 523 (9th Cir. 1938) and *Overton v. Sampson,* 138 F.2d 417 (9th Cir. 1943). In those cases the Court held that only one-half of California community property in which husband and wife had present, existing and equal interests was includible in the husband's gross estate for estate tax purposes. As will be discussed later, the same rule has been applied even though the wife elected to take under the husband's will. See *The Pacific National Bank*

of Seattle, Executor, 40 BTA 128 (1939), acq. 1939-2 CB 28, discussed *infra,* page 18.

The *Bishop* case has been followed in cases considering the community property laws of several other states.

> *Blackburn's Estate v. Commissioner,* 180 F.2d 952 (5th Cir. 1950) (Texas);
>
> *Estate of J. T. Sneed, Jr.,* 17 T.C. 1344 (1952), aff'd 220 F.2d 313 (5th Cir. 1955) (Texas);
>
> *United States v. Merrill,* 211 F.2d 297 (9th Cir. 1954) (Washington), overruling *Commissioner v. Larson,* 131 F.2d 85 (9th Cir. 1942).

The Internal Revenue Service has announced recently that it will now apply the rule of the *Bishop* case to all states with community property laws similar to those of California.

> Revenue Ruling 55-726, Internal Revenue Bulletin No. 51, p. 6 (Dec. 19, 1955).

In the present case the parties have stipulated that:

> "At the date of death all of the property owned by decedent and all of the property owned by decedent's wife was community property in which, during the continuance of the marriage relation, decedent and decedent's wife had present, existing and equal interests. Walter's Estate was composed entirely of the property referred to in the foregoing (sentence) * * *" (R. 18, Stip. par. 4).

Therefore, appellant submits that since all of the property of Walter's Estate was community property in which the parties had present, existing and equal interests at the date of decedent's death, the rule of the *Bishop* case is a binding precedent and only one-half of the income

of Walter's Estate should have been taxed to the estate for the period here in question.

B. The Effect of the Waiver Signed by Decedent's Wife.

Before the District Court appellee argued that the *Bishop* case was not controlling because decedent's wife made a binding contract to relinquish her interest in the community property through the waiver which she signed. The District Court adopted appellee's argument (R. 39-42). This argument advanced by the appellee may be answered in a three-fold manner.

In the first place, in construing the effect of the waiver under California law we are required to look at both decedent's will and the waiver. *Estate of Whitney,* 171 Cal. 750, 154 Pac. 855 (1916). In construing both documents it is apparent that there was no binding agreement that the wife give up her interest in one-half of the community property at the husband's death. By the terms of her waiver, decedent's wife accepted the terms of decedent's will and waived her right to claim one-half of the community property (Ex. 2). However, under the terms of decedent's will, all of his estate[3] was transferred to the Emily A. Gibson Trust Estate and the will stated:

> "My said wife shall also be entitled to withdraw such portions of the corpus of said Emily A. Gibson Trust Estate (not exceeding, however, in all one-half (½) of the amount of the corpus thereof) from time to time and for any purpose as she may desire" (Ex. 1).

[3]All of Walter's Estate was distributed to the Emily A. Gibson Trust Estate with the exception of certain small bequests which it is stipulated "may be disregarded in this proceeding" (R. 18, Stip. par. 3).

Thus under the waiver decedent's wife agreed to take under decedent's will and to give up her interest in one-half of the community property, but under the terms of the will, which was also a part of her agreement, she had the unconditional right to withdraw one-half of Walter's Estate at any time. Furthermore, decedent's wife did withdraw one-half of Walter's Estate on May 8, 1941, prior to the date of final distribution of the estate (R. 18, Stip. par. 3). In summary, then, decedent's wife had the right to revoke her agreement at any time and withdraw her consideration. Under those facts the so-called waiver contract lacked mutuality of obligation and consideration and was therefore unenforceable.

Thus in *Shortell v. Evans-Ferguson Corp.*, 98 Cal.App. 650, 277 Pac. 519 (1929), the plaintiff signed an agreement and deposited $2,500 to purchase lots by reference to an unrecorded map, the defendant seller to furnish a contract of sale or deed when the map was recorded. Defendant seller also reserved the right to return the money at any time before a contract of sale was entered into between the parties and thereby revoke the agreement. Plaintiff sued for the full recovery of his deposit on the ground that the agreement was unenforceable. The Court held for the plaintiff on the ground that the agreement lacked consideration and was unenforceable because the defendant could revoke it at any time.

In *Naify v. Pacific Indemnity Co.*, 11 C.2d 5, at page 11 (1938), the Court recognized this rule of contract law stating:

> "* * * a contract must have mutuality of obligation, and an agreement which permits one party to withdraw at his pleasure is void."

A further statement of the law is contained in *County of Alameda v. Ross*, 32 C.A.2d 135, at page 145, 89 P.2d 460 (1939), where the Court said:

> "It has been frequently held that agreements are void which contain indefinite and uncertain provisions with respect to the obligations and for lack of mutuality, and consideration, particularly when they contain an absolute and unconditional right of revocation by either party (citing a number of cases)."

See also: Restatement of Contracts, sec. 79.

Thus in the present case there was no binding agreement entered into between decedent and decedent's wife because decedent's wife gave no consideration. Decedent's wife could retake her consideration at any time and in fact she did. Since the agreement is not an effective contract, the interest of decedent's wife in her one-half of the community property was in no way affected by the so-called waiver agreement. Thus the interest of decedent's wife was the same as that of the wife in the *Bishop* case, and that case requires that one-half of the income from Walter's Estate be taxed to deecdent's wife.

C. One-half of the Income of Walter's Estate Should Be Taxed to Decedent's Wife Even If the Waiver Is Binding.

Even if the Court should find that the waiver signed by decedent's wife is binding upon her, one-half of the income from Walter's Estate is nevertheless taxable to the wife. Again it is necessary to determine, under the rule of the *Bishop* case, where control of the community interest of decedent's wife resides. It is a fact that decedent's wife had the right to withdraw one-half of

Walter's Estate at any time and that she did withdraw one-half of Walter's Estate on May 8, 1941 (R. 18, Stip. par. 3, Exs. 1 and 2). The one-half of Walter's Estate over which decedent's wife had complete control was subject to administration in the husband's estate, but that fact does not make the property in any way different from a wife's one-half of the community property, for her community interest is also subject to administration in the deceased husband's estate. See section 202, California Probate Code, quoted above. The basic "test of taxability" said the Court in the *Bishop* case is that of ownership or control. In the *Bishop* case the Court held that the wife owned one-half of the community property after her husband's death because when the community terminated at the death of the husband California Probate Code section 201, quoted above, gave the wife that ownership. And in the present case, even if the Court should hold that decedent's wife effectively relinquished her community interest, still by contract (construing the waiver of decedent's wife and decedent's will together) she obtained ownership and control of one-half of Walter's Estate. Therefore, under the "test of taxability" of the *Bishop* case one-half of the income of Walter's Estate is taxable to decedent's wife.

Furthermore, if the Court should find the waiver to be binding upon decedent's wife there is an additional reason for taxing one-half of the income from Walter's Estate to decedent's wife. Decedent's wife controlled one-half of the community property down to the date of decedent's death for the waiver was only effective "upon his death prior to my decease" (Ex. 2). If the waiver is effective,

a proper analysis of the facts would show that at the date of decedent's death, his wife contributed her one-half of the community property to the testamentary trust set forth in decedent's will. In effect, she was a co-trustor of the trust in regard to her one-half of all the community property and decedent was a co-trustor in regard to his one-half of all the community property. Decedent's will which described the trust, and to which decedent's wife agreed, gave decedent's wife the right to withdraw one-half of the corpus of the trust. Thus, in effect, decedent's wife could at any time revoke her contribution to the trust.

From the time of the Revenue Act of 1924, federal income tax law has provided that where the grantor of a trust has the power to revoke the trust, the income of the trust is taxable to the grantor. See, *e.g.,* section 166, Internal Revenue Code of 1939; section 676(a), Internal Revenue Code of 1954. Section 166, Internal Revenue Code of 1939 was controlling for that part of the year 1941 which is here in controversy, and it provides:

> "Sec. 166. *Revocable Trusts.*
>
> Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—
>
> (1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or
>
> (2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

> then the income of such part of the trust shall be included in computing the net income of the grantor."

Therefore, one-half of the income of the testamentary trust, which trust for the purposes of this case comprises the whole of Walter's Estate, must be taxable to decedent's wife.

This analysis of the effect of the waiver, if the Court finds that the waiver is binding, is borne out by two decisions of the Board of Tax Appeals construing the effect of waivers under the federal estate tax, and by California probate law.

In *The Pacific National Bank of Seattle, Executor,* 40 BTA 128 (1939), acq. 1939-2 CB 28, husband and wife had accumulated community property in the State of Washington. The wife signed the following statement on the same day her husband signed his will:

> "* * * I hereby elect to and do accept * * * said Will and all of its provisions, including disposition at the death of my said husband of all our community property thereunder, and hereby waive all claims to my share of any community property * * *."

The Commissioner argued that by signing such a statement the wife transferred her community property to her husband during her lifetime and, therefore, the wife's share of the community property must be included in the husband's gross estate in computing the federal estate tax. The Board held, however, that the wife's share of the community property was not includible in the husband's gross estate. The wife's transfer of her share of the community property was only effective on the hus-

band's death. At that time the wife's interest passed directly from her to the trust established by the husband's will and was never a part of the husband's taxable estate. The Board reaffirmed its previous holding in *Coffman-Dobson Bank & Trust Co.,* 20 BTA 890 (1930), acq. X-1 CB 13 (1931). Thus under those decisions the Board of Tax Appeals held that the community interest of the wife passed at the husband's death directly from the wife and never became a part of the husband's taxable estate. The Commissioner acquiesced in both decisions and has never withdrawn either acquiescence.

These decisions are in accord with the probate law of the State of California. In this State the testamentary trust comes into existence and the legal title to the property included therein vests in the trustee at the death of the testator; a decree of distribution of the estate to the trustee operates merely to confirm such title in the trustee.

> *California Probate Code,* secs. 28, 300;
> *Estate of Lefranc,* 38 C.2d 289, 297, 239 P.2d 617 (1952);
> *Estate of Wellings,* 192 Cal. 506, 510, 221 Pac. 628 (1923);
> *Estate of O'Connor,* 2 Cal.App. 470, 84 Pac. 317 (1905).

Furthermore, the equitable interests of the trust beneficiaries come into existence at the testator's death.

> *Title Ins. & Trust Co. v. Duffill,* 191 Cal. 629, 218 Pac. 14 (1923).

Thus the testamentary trust in the present case came into existence at the time of the testator's death and was

ready to receive a transfer of community property from the wife at that time. Of course, the trust property is subject to administration in the husband's estate. California Probate Code, section 202, quoted above. But this does not diminish the fact of control by decedent's wife, for, as the *Bishop* case recognized, the wife's share of the community property is always subject to administration in the husband's estate and yet the income from the wife's community interest is taxable to her during administration of the husband's estate.

The above resume of the two Board of Tax Appeals' decisions and the applicable California probate law clarifies the law in regard to the present proceeding. For even if the Court should find the waiver signed by decedent's wife to be an effective agreement, still under the rationale of the Board decisions, fully supportable under California law, the community interest of decedent's wife only passed from her at decedent's death directly to the testamentary trust set forth in decedent's will and never became a part of decedent's taxable estate. And, if the fact is added that in the present case decedent's wife never lost control or ownership of one half of the trust corpus, the conclusion is inescapable that decedent's wife must be taxed on one-half of the income from Walter's Estate under section 166, Internal Revenue Code of 1939, which taxes to the grantor the income of a revocable trust.

Thus if the Court should determine that the waiver, signed by decedent's wife, and decedent's will constitute together a binding agreement, nevertheless, one-half of the income from Walter's Estate is taxable to decedent's wife. This result must follow because decedent's wife owned

one-half of Walter's Estate to the same extent and degree as the wife in the *Bishop* case owned one-half of the community property after her husband's death. Furthermore, decedent's wife was a co-trustor of the trust set forth in decedent's will with a power to revoke her contribution.

The District Court was of the opinion that the right of decedent's wife to withdraw 50 per cent of Walter's Estate was not effective to give her an interest in the estate similar to that of the wife in the *Bishop* case because in the present case "under no circumstances could the wife obtain any ownership or control until a distribution was effected on the estate of her husband" (R. 41). As we have demonstrated above, however, the District Court's rationale in regard to the power to withdraw is in error for two reasons. In the first place, decedent's wife owned one-half of the property subject to administration in Walter's Estate before his death and an interest equivalent to ownership in one-half of the property after his death. Secondly, the fact that the interest of decedent's wife was subject to administration in Walter's Estate, so that decedent's wife could not "control" it until distribution of the estate, is not of importance. The community property interest of the wife in the *Bishop* case was also subject to administration in her husband's estate and she could not "control" it until distribution. This Court recognized this fact in the *Bishop* case, but held it was not determinative. Thus the District Court did not properly apply the holding in the *Bishop* case, and, therefore, its judgment should be reversed.

II.

THE DEFENSE OF EQUITABLE RECOUPMENT.

As an alternative defense in its answer appellee avers that its right to retain the amount for which the appellant is suing in this action is superior to any right asserted by appellant. The basis for appellee's claim seems to be that: (1) The statute of limitations had run against any assessment which might be made against Emily A. Gibson, deceased; (2) the beneficiaries of Walter's Estate and of Emily's Estate are substantially the same; and (3) therefore, any recovery by appellant would redound to the benefit of the beneficiaries of Emily's Estate, which beneficiaries would have borne the burden of the tax which the Commissioner should have assessed against Emily A. Gibson, deceased.

A. The Narrow Scope of the Doctrine of Equitable Recoupment.

There is no statutory authority for the doctrine of equitable recoupment. The doctrine is based primarily on two Supreme Court cases, *Bull v. United States,* 295 U.S. 247 (1935), and *Stone v. White,* 301 U.S. 532 (1937). A brief discussion of the two cases will illustrate how the doctrine was applied. In *Bull v. United States, supra,* the estate of a deceased partner received a share of the partnership profits during the year 1921. The Commissioner treated the profits so paid in 1921 as part of the corpus of his estate and an estate tax was paid thereon. In 1925 the Commissioner determined a deficiency in income taxes against the estate on its share of the 1921 partnership profits. The estate claimed that the 1925 assessment was erroneous but the claim was rejected in 1928. By

this time the statute of limitations had run against the estate's right to sue for a refund on the estate taxes paid on 1921 income. Thus the estate paid the 1925 income tax assessment under protest and sued for a refund claiming that if the income tax assessment was correct and the estate tax assessment was erroneous, it had a right to recoup the estate tax. The Supreme Court upheld the taxpayer's contention, holding that the 1925 assessment of income taxes was the correct one, but that the estate tax paid in 1921 could be recouped.

In *Stone v. White, supra,* a testator left property in trust with his wife as sole income beneficiary. The beneficiary did not include the income paid to her in her taxable income, nor did the trustees pay tax on the income. The Commissioner, relying on the prevailing authorities at that time, determined a deficiency against the trustees which was paid. Thereafter the Supreme Court, at a time when an assessment against the beneficiary was barred by the statute of limitations, held in another similar case that the income was taxable to the beneficiary and not to the trust. The trustees in the *Stone* case thereupon brought a suit for refund and the Collector interposed the defense that the tax which should have been paid by the beneficiary exceeded that paid by the trustees, and that if any recovery would inure to the advantage of the beneficiary, the Collector could set off the tax due from her. It was shown that the trustees paid the tax out of trust income and under the trust a recovery by the trustees would go directly to the beneficiary. The Supreme Court held that the Collector could recoup the tax due from the beneficiary, stating that here

the trustee and beneficiary might be treated as a single entity.

The doctrine of equitable recoupment as enunciated in the two Supreme Court cases above mentioned, has been severely limited by succeeding Supreme Court and lower Court decisions. The right of the government to rely on equitable recoupment as a defense was almost eliminated by *McEachern v. Rose,* 302 U.S. 56 (1937). There the Court refused to permit the government to recoup a barred deficiency for 1928 against overassessments of the same taxpayer for 1930 and 1931. The Court relied on sections 607 and 609, Revenue Act of 1928, which have been carried into sections 3770(a)(2) and 3775(a), Internal Revenue Code of 1939; sections 6401(a) and 6514(b), Internal Revenue Code of 1954. It is true that the Court in *Stone v. White, supra,* refused to apply these sections on the ground that they pertain only to a case where the underpayment and overpayment were made by one taxpayer rather than two taxpayers as is the case in *Stone v. White* and the present case. However, the effect of *McEachern v. Rose* was practically to eliminate the doctrine of equitable recoupment as a defense available to the government in a case where the underpayment and overpayment related to one taxpayer.

The availability of the doctrine of equitable recoupment to the taxpayer suing for a refund has also been severely limited by the Supreme Court. In *Rothensies v. Electric Storage Battery Co.,* 329 U.S. 296 (1946), the Court refused to permit a taxpayer to offset barred overpayments of federal excise taxes paid for the years 1919 through 1922 against income taxes for the year 1935.

After reviewing the holdings in *Bull v. United States, supra,* and *Stone v. White, supra,* the Court emphasized that the doctrine of equitable recoupment was not to be extended beyond the facts of those cases.

As a further limitation, the Supreme Court has held that the Tax Court has no authority to apply the doctrine of equitable recoupment. *Commissioner v. Gooch Milling & Elevator Co.,* 320 U.S. 418 (1943).

The narrowing effect of the later Supreme Court cases has led Judge Frank of the Second Circuit to say:

> "The gap in statutes of limitation created by the recoupment doctrine in tax cases seemed at one time to be fairly wide. But the gap has been narrowed markedly by McEachern v. Rose (*supra*) and Rothensies v. Electric Storage Battery Co. (*supra*). Frankly, we do not know just how much of that doctrine still lives * * *."
>
> *Wood v. United States,* 213 F.2d 660 (1954), aff'g 121 F.Supp. 764 (S.D. N.Y. 1953).

For a general discussion of the doctrine of equitable recoupment see, Mintz and Plumb, *"Taxing Income in Years Not Realized Under Doctrine of Equitable Estoppel," 1954 Tax Institute, University of Southern California, School of Law,* 481, 504-506, 513-515.

The Supreme Court cases above discussed show that the doctrine of equitable recoupment is not to be extended beyond the fact situations contained in *Bull v. United States, supra,* and *Stone v. White, supra.* The fact situation in the present case is not at all analogous to the facts of those two Supreme Court cases. Therefore, the defense of equitable recoupment is not available in this

case as the following lower Court decisions construing the Supreme Court decisions conclusively show. Those lower Court decisions set forth two principal reasons for the inapplicability of the doctrine in this case: (1) The Commissioner neglected to assess the tax which he is attempting to recoup against Emily A. Gibson, deceased, when he had a reasonable time within which to make the assessment; and (2) there is not the necessary identity of parties as between the beneficiaries of Walter's Estate and the beneficiaries of Emily's Estate. Appellant further submits that the doctrine of equitable recoupment is not available because the Internal Revenue Code provides the Commissioner with a procedure for assessing and collecting the tax from Emily A. Gibson, deceased, and the Commissioner should be limited to his statutory remedy in a matter of this type. These limitations on the doctrine of equitable recoupment will be discussed in the following paragraphs.

B. The Commissioner's Laches Prevents Application of the Doctrine.

First, it is clear from the facts that the Commissioner had a reasonable time within which to assess the tax against Emily A. Gibson, deceased, and he neglected to act. In this case the Commissioner assessed an additional tax against Walter's Estate in the sum of $9,161.19 and advised Emily A. Gibson, deceased, that she was entitled to a refund in the sum of $7,359.84 (R. 19, 21, Stip. pars. 7 and 10). The overassessment due Emily A. Gibson, deceased, was ultimately paid by crediting that amount against the deficiency due from Walter's Estate which transaction occurred on July 11, 1945 (R. 22, Stip. par.

11). On the same day Walter's Estate reimbursed Emily's Estate (R. 22, Stip. par. 12). In effect, therefore, Emily A. Gibson, deceased, received a tax refund on July 11, 1945. Under section 3746(b), Internal Revenue Code of 1939, the Commissioner had two years, or until July 11, 1947, within which to collect this erroneous refund. The case of *Bishop v. Commissioner, supra,* was decided by the Ninth Circuit on December 10, 1945. The Commissioner did not apply for certiorari in the case and, therefore, it represented a final decision determining that one-half of the income from this estate should be taxed to decedent's wife. The Commissioner had approximately 18 months after the *Bishop* decision to collect the tax erroneously paid to Emily A. Gibson, deceased. However, he failed to take any steps to collect the tax or to protect himself against the bar of the statute of limitations. The following cases clearly demonstrate that such laches on the part of the Commissioner, a factor not present in *Stone v. White, supra,* prevents the appellee from successfully asserting the doctrine of equitable recoupment.

In *McNaghten v. United States,* 17 F.Supp. 509 (Ct. Cl. 1937), the Commissioner had assessed a tax based on distributions from a trust to two beneficiaries each in the amount of $430,000. The trust beneficiaries sued for refunds on the ground that under state law there was only a taxable distribution of $354,000 to each of them. The Court found for the beneficiaries on this claim. The government asserted a second defense, however, based on the fact that the trust should have paid the tax in the case of both beneficiaries on the excess over $354,000, but that collection of the tax from the trust was barred by the

statute of limitations. Therefore, the government argued that the amount of tax which should have been paid by the trust could be recouped against the refund otherwise owing to the beneficiaries. The Court refused to allow recoupment, stating as follows:

> "* * * under the facts and circumstances of this case, we find no justification for the application of the equitable principle for which defendant's counsel contends. In the case of White v. Stone et al., supra, the Commissioner determined and assessed the tax there involved in accordance with the decision of the Circuit Court of Appeals for the circuit in which the taxpayer resided, which decision was later reversed, while in the case at bar the Commissioner was bound by no interpretation of the law, except his own, with respect to the question before him. *Moreover, all the facts necessary to a determination and assessment of taxes against the trustees and the beneficiaries of the Arthur Letts Trust were before him and fully known by him on and prior to July 1, 1930, about 8½ months before any statute of limitation would run against the legal assessment of any tax for 1927 against the trustees. He simply neglected properly to assess the tax and permitted the limitation statute to run.* There were no representations of any kind by plaintiffs that misled, or could have misled, the Commissioner, and there is no basis for estoppel" (p. 515, Italics supplied).

The *McNaghten* case was followed in *Benfield v. U.S.,* 27 F.Supp. 56 (Ct.Cl. 1939), where a widow sued for a refund of income tax paid on annuities received from a trust set up by her husband's will for that purpose. The annuities were composed partly of trust corpus and partly

of trust income. The Court held that the annuities were in the nature of a legacy and not taxable to the widow, and refused to allow recoupment of the barred tax due from the trustees against the refund otherwise owing to the widow. Before collection of the tax due from the trustees was barred, the Commissioner had notified the widow in a 30-day letter that there had been an overassessment of income tax and she was advised to file a claim for refund, which claim was rejected when filed. These facts the Court thought brought the case within the rule of the *McNaghten* case, in that the Commissioner assessed the wrong taxpayer even though he had full knowledge of all the facts.

Again, in *Wood v. United States, supra,* the District Court emphasized the failure of the Commissioner to act in a timely fashion where an adverse decision was rendered against him. The *Wood* case involved a taxpayer's suit for a refund of income taxes for 1944 against which the Commissioner was attempting to recoup a deficiency in plaintiff's tax for 1945, assessment of which was barred by the statute of limitations. The District Court noted that the case which formed the authority for taxpayer's right to a refund for 1944 as well as Commissioner's right to a deficiency assessment for 1945 was first decided by the Tax Court on June 2, 1948 (*Christian W. Korell,* 10 T.C. 1001, aff'd 176 F.2d 152 (2nd Cir. 1949), aff'd 339 U.S. 619 (1950)). The time within which the Commissioner could have assessed a deficiency expired on April 6, 1949. The Court noted: "However, nothing appears to have been done to keep open the matter of this taxpayer's proper income tax for the year 1945"

(p. 767). On a consideration of the whole case the District Court denied the major part of defendant's claim for recoupment and the rest of defendant's claim was denied on appeal.

A similar problem was considered in *United States v. S. F. Scott & Sons, Inc.*, 69 F.2d 728 (1st Cir. 1934), where the government relied on the same type of defense but called it "estoppel" rather than "equitable recoupment." Here a business was operated as a sole proprietorship until June 28, 1919, when it was incorporated. The Commissioner assessed taxes on the income earned for 1918 against the corporation and granted a refund to the former individual owner who had paid taxes on the 1918 income of the business. The corporation sued for a refund. The government eventually conceded that the former individual owner and not the corporation should have been taxed for 1918, but argued against a refund to the corporation on the ground that the statute barred an assessment against the former owner and thus if a refund was allowed no tax would be paid on the 1918 income. The Court rejected the government's defense based on the contention that no tax would be paid on 1918 income because "such a result (was) due to a misinterpretation of the law and its own laches in failing to bring suit to recover a refund erroneously made by one of its officials" (p. 732).

C. Lack of Identity of the Parties Prevents Application of the Doctrine.

Second, the following cases conclusively show that the lack of identity of the parties as between the beneficiaries of Walter's Estate and the beneficiaries of Emily's Estate

prevents the application of the defense of equitable recoupment. As stated heretofore, the earlier cases in which the Supreme Court permitted the application of the doctrine of equitable recoupment were cases where the parties who would bear the burden of paying a double tax on specified income or who would receive the benefit of a refund which would mean that no tax would be paid on specified income were the *same person or entity.* Thus in *Bull v. United States, supra,* the estate had to pay both an estate tax and an income tax on specified income, and in *Stone v. White, supra,* any refund would have inured directly to the trust beneficiary who would have had to pay the tax on the income but for the statute of limitations.

In the present proceeding Walter D. K. Gibson, Jr., and Grace Collins are equal residuary legatees of Emily's Estate (R. 26, Stip. par. 20).

If a judgment is rendered for the appellant herein, the refund thereby payable to appellant will be distributed as follows:

(a) One-half in trust to the Crocker First National Bank of San Francisco (Grace Collins and Walter D. K. Gibson, Jr., being the life income beneficiaries with powers of appointment and the trust providing for takers in default of appointment);

(b) One-eighth outright to Walter D. K. Gibson, Jr.;

(c) One-eighth in trust to Joanne Gibson, net income payable to her until she reaches age 30 when she will receive the corpus; and

(d) One-fourth in trust to Grace Collins, net income payable to her during her lifetime with remainders over

(R. 33, Supplemental Stip. par. 2, amending Stip. par. 21). Thus, the beneficiaries of Walter's Estate and Emily's Estate lack substantial identity. Only in the case of Walter D. K. Gibson, Jr., is there an outright transfer from Walter's Estate (one-eighth interest) and also from Emily's Estate. The other parties having an interest in Walter's Estate are two trusts in which Walter D. K. Gibson, Jr., and Grace Collins are life beneficiaries, and Joanne Gibson, who has no interest in Emily's Estate. Such a lack of identity clearly prevents the application of the doctrine of equitable recoupment.

In *Benfield v. U. S., supra,* the Court refused to apply the doctrine of equitable recoupment in a case involving facts close to those in the present proceeding. In the *Benfield* case a widow sued for a refund of income tax paid upon annuities received from a trust set up by her husband's will for that purpose. The Court held that the annuities were not taxable to the widow and refused to allow recoupment of the barred tax due from the trustees against the refund otherwise owing to the widow. One ground for the Court's decision, previously discussed, was that the Commissioner had failed to act in a timely fashion against the trustees who should have paid the tax. A second ground for refusing to apply the doctrine of equitable recoupment was the lack of identity of the parties. Pending the decision in the widow's refund action, the widow had died. The beneficiaries of the widow's estate were her three children. The beneficiaries of the husband's estate were the same three children, the issue of two of the children, and two other parties. The husband's estate should have paid the tax and therefore

the beneficiaries of his estate would have borne the burden of the tax but for the statute of limitations. Thus, the refund claimed on behalf of the widow would benefit the three beneficiaries who were also beneficiaries of the husband's estate which should have paid the tax. The fact situation, therefore, is close to that in the case at bar except that here the husband's estate is asking for the refund.

The Court noted that the beneficiaries of the husband's estate and the wife's estate were not the same and stated that this lack of identity was a ground for refusing to apply the doctrine of equitable recoupment. The Court said, "If this suit is successful, the recovery will go to the heirs of (the widow's) estate and the beneficiaries of her estate are a part but not all of the beneficiaries of the estate of James Harrington Walker (the husband). These facts show merely an undetermined advantage derived through the failure of the trustees of James Harrington Walker to pay the tax, which is insufficient to warrant the application of the doctrine of equitable estoppel" (27 F.Supp. 859). In refusing to follow *Stone v. White, supra,* because of the lack of identity of the beneficiaries, the Court cited *Schlemmer v. U. S.,* 94 F.2d 77 (2nd Cir. 1938), and *Sewell v. United States,* 19 F.Supp. 657 (Ct.Cl. 1937).

In the *Schlemmer* case the plaintiff and X, together with their wives, were stockholders of the corporation. The plaintiff and X were also officers and directors of the corporation and in the year 1927 they voted themselves each a salary of $30,000. The corporation could not pay the compensation, however, and sometime late in 1927

or early in 1928 the corporation gave plaintiff and X each a note for $30,000. Except for $3,000 paid to plaintiff in 1929 the notes were never paid. Both the corporation and the plaintiff were on the cash basis. However, for the year 1928 the corporation deducted the amount of both notes from its income and the plaintiff reported his note as income and paid the tax thereon. The plaintiff later brought this suit for a refund of the tax so paid.

The Court held for the plaintiff. The note did not constitute income to the plaintiff because the parties did not intend it to be the payment of the corporation's debt. The government argued, however, that the equitable recoupment theory of *Stone v. White, supra,* should prevent recovery by the plaintiff because if plaintiff should not have reported the note as income, the corporation should not have deducted the note from its gross income and the statute of limitations had run against assessing the corporation. The Court, per Judge Learned Hand, held that the doctrine of *Stone v. White* was not applicable in this case. In the *Stone* case "the tax was due from the beneficiary in one form or another, and it was unfair to allow the trustee to recoup himself for the beneficiary's account. Here, however, we cannot say on whom the tax due from the company would have fallen, if the notes had not been deducted." The Court noted that plaintiff would have paid some part of it because he was a stockholder, but there were other stockholders in the corporation and creditors also. The Court continued:

> "Of course, it may be possible to figure out just how much the plaintiff will gain by this refund, were all the facts before us; which they are not. But, if they

> were, we do not read *Stone v. White* * * * as meaning that in such a case the creditor must submit to a set-off, so computed. The trustee was there for practical purposes the beneficiary in other clothes; we do not believe that the eventual incidence of the tax which has been lost, may be traced back, however indirectly, to the taxpayer in court so that his recovery shall be diminished pro tanto."

In *Sewell v. United States, supra,* the wife was the beneficiary of the husband's testamentary trust and was entitled to part of the trust income for life, the remaining income to be accumulated and added to the corpus. For the year 1937 part of the income was distributed to the wife and the trustee paid a tax thereon out of income which otherwise would have been accumulated. Later Court decisions determined that the wife should have paid the tax and the trustee sued for a refund. The government defended on the ground of equitable recoupment because the wife, who should have paid the tax, was protected from assessment by the statute of limitations. The Court refused to apply the doctrine of equitable recoupment, however, on the ground that the refund would become part of the trust corpus and would never actually be received by the wife. Thus, the doctrine of equitable recoupment as enunciated by *Stone v. White, supra,* would not apply.

A similar decision was rendered in *Proctor v. White,* 28 F. Supp. 161 (D. Mass. 1939), where the husband was a one-sixth income beneficiary in the wife's estate. The executors sued for a refund of taxes paid on the income received by the husband who should have paid the tax but who could not be required to because of the statute of

limitations. In regard to a refund which would go to the corpus of the estate the Court said:

> "The most profit that Proctor (the husband) would receive would be his 1/6 share of the income from the sum returned for his life under the terms of the will."

The husband's interest in the refund was not sufficient to invoke the doctrine of equitable recoupment.

D. Internal Revenue Code Procedures Supersede Equitable Recoupment.

A third reason for the inapplicability of the doctrine of equitable recoupment in this case is found in specific provisions of the Internal Revenue Code of 1954, sections 1311-1314, which set forth a procedure for the Commissioner to use in collecting taxes from "related taxpayers" such as Emily A. Gibson, deceased. Under the facts, Emily A. Gibson, deceased, was advised in a 30-day letter dated January 25, 1949, that a deficiency in income taxes for the period ended November 24, 1941, had been proposed in the amount of $7,100.35 (R. 25, Stip. par. 17). Emily A. Gibson, deceased, protested said proposed deficiency on the grounds that the statute of limitations had expired and that section 3801 of the Internal Revenue Code of 1939 providing an extended statute in regard to related taxpayers would not apply to her. Thereafter, the Internal Revenue Agent in Charge at San Francisco made the following conclusions in regard to the proposed deficiency against Emily A. Gibson, deceased:

> "That the report of the examining officer be modified to reflect no deficiency at this time pending the obtaining of a final determination of the income tax

liability of the estate of Walter D. K. Gibson, deceased, for the year 1941" (R. 25, Stip. par. 18).

No statutory notice of deficiency has ever been issued by the Commissioner against Emily A. Gibson, deceased, or Emily's Estate for the amount of $7,100.35.

If the appellant obtains a judgment in this case, the Commissioner has the opportunity to proceed against Emily A. Gibson, deceased, or her transferees, under sections 1311-1314 of the Internal Revenue Code of 1954 (the successor sections to section 3801 of the Internal Revenue Code of 1939). These sections of the Code were specifically enacted by Congress to provide an extended statute of limitations in cases where income was erroneously reported by one taxpayer, which income should have been reported by a related taxpayer. This is the statutory method specifically devised by Congress for settling tax liability of a related taxpayer such as Emily A. Gibson, deceased.

It is submitted that since Congress has established a specific legal remedy for the collection of taxes in cases such as this, the appellee has no standing to assert any equitable remedy until it has exhausted its legal remedy.

CONCLUSION.

Appellant submits that the judgment of the District Court should be reversed and the judgment prayed for in its complaint should be granted. This action is governed by the rule of this Court in *Bishop v. Commissioner,*

supra. Furthermore, appellee is not in a position to invoke the doctrine of equitable recoupment, even if such a doctrine still exists in the law of federal taxation.

Dated, San Francisco, California,
June 1, 1956.

Respectfully submitted,
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